Supreme Court, U.S.
FILED
DEC 08 2006
OFFICE OF THE CLERK

No. 06-947

IN THE

Supreme Court of the United States

GEORGE and ANGELINE LATTERA,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

MARK E. CEDRONE
CEDRONE & JANOVE
Suite 940 Public Ledger Building
150 South Independence Mall West
6th and Chestnut Streets
Philadelphia, Pennsylvania 19106
(215) 925-2500

Attorneys for Petitioners

205776

COUNSEL PRESS
(800) 274-3321 • (800) 359-6859

QUESTION PRESENTED FOR REVIEW

Whether the lower court erred in holding, despite clear and unambiguous statutory language to the contrary, that proceeds from the sale of the right to receive a series of lottery annuity payments was not the sale of a capital asset and that the gain realized was ordinary gain.

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Petitioners, George and Angeline Lattera, respectfully request a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Third Circuit which was entered in this case on February 14, 2006 (amended on April 5, 2006) with rehearing being denied on August 11, 2006.

OPINIONS BELOW

The Opinion of the United States Court of Appeals for the Third Circuit is reported at *United States v. Lattera*, 437 F.3d 399 (3d Cir. 2006) and is found in the Appendix (App. A). The Memorandum and Order of the United States Tax Court in *Lattera, v. Commissioner of Internal Revenue,* Docket No. 4269-03, was entered on September 23, 2004 and can be found in the Appendix. (App. B). The Order of the United States Court of Appeals for the Third Circuit denying rehearing dated August 11, 2006 is found in the Appendix. (App. C).

STATEMENT OF JURISDICTION

The jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 1254(1).

This case commenced on December 17, 2002 after Respondent issued a "Notice of Deficiency" to Petitioners in which Respondents made adjustments to Petitioners' income tax liability for the year 1999. On March 17, 2003, Petitioners filed a timely petition in the United States Tax Court challenging Respondent's redetermination of the capital gain from the sale of a lottery annuity as ordinary income. On September 23, 2004, the United States Tax Court issued an opinion adverse to Petitioners and entered a

"Decision" in favor of Respondent. (App. B). On December 16, 2004, Petitioners sought review of the decision before the United States Court of Appeals for the Third Circuit. The Court of Appeals affirmed the decision of the Tax Court by Opinion and Judgment dated February 14, 2006 (amended April 5, 2006). (App. A).

It is from that judgment (App. A) that Petitioners requested a writ of certiorari be issued.

STATUTORY PROVISIONS INVOLVED

In relevant part, the United States Code in effect at all times relevant to this case provided:[1]

The Internal Revenue Code defines "a capital asset" as follows:

> (a) In general
>
> For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include–
>
> (1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close

1. In 1999, eight years after Petitioners sold their lottery rights, the relevant statutory provision at issue in this case, specifically, 26 U.S.C. §1221, was amended in a way not relevant to this case. All statutory citations will be to code sections as they were codified during the relevant time period.

of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business;

(3) a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by

(A) a taxpayer whose personal efforts created such property,

(B) in the case of a letter, memorandum, or similar property, a taxpayer for whom such property was prepared or produced, or

(C) a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of a taxpayer described in subparagraph (A) or (B);

(4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1);

(5) a publication of the United States Government (including the Congressional Record) which is received from the United States Government or any agency thereof, other than by purchase at the price at which it is offered for sale to the public, and which is held by

(A) a taxpayer who so received such publication, or

(B) a taxpayer in whose hands the basis of such publication is determined, for purposes of determining gain from a sale or exchange, in whole or in part by reference to the basis of such publication in the hands of a taxpayer described in subparagraph (A)

26 U.S.C. § 1221.

For purposes of this subtitle– . . .

(3) Long-term capital gain.–The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 1 year, if and to the extent such gain is taken into account in computing gross income.

26 U.S.C. § 1222.

STATEMENT OF THE CASE

A. Proceedings and Disposition in the Courts Below

On December 17, 2002, Respondent issued a "Notice of Deficiency" to Petitioners in which Respondent made adjustments to Petitioners' income tax liability for the year 1999. Specifically, Respondent's Notice of Deficiency asserted a $660,748.00 deficiency in Petitioners' income tax liability for the 1999 tax year flowing from Respondent's reclassification of Petitioners' reported sale of the proceeds of a lottery annuity as ordinary income.

On or about March 17, 2003 Petitioners timely filed a petition in the United States Tax Court challenging Respondent's redetermination of the capital gain from the sale of a lottery annuity as ordinary income. On or about October 20, 2003, the matter was submitted to the United States Tax Court based on an agreed to factual record, and after post-submission briefing the United States Tax Court issued an Opinion adverse to Petitioners and entered a "Decision" in favor of Respondent. (App. B). Thereafter, Petitioners sought review before the United States Court of Appeals for the Third Circuit. On February 14, 2006, the Third Circuit Court of Appeals issued its Judgment and Opinion, affirming the Tax Court's decision. The Third Circuit's Judgment and Opinion are attached hereto. (App. A and B).

Petitioners timely filed a petition for rehearing with the Third Circuit Court of Appeals. On August 11, 2006, the court below denied Petitioners' request for rehearing. (App. C).

Petitioners timely filed with this Court an application under Supreme Court Rule 13(5) requesting an extension of time in which to petition this Court for a writ of certiorari. This Court extended the deadline by which Petitioners must file this petition for writ of certiorari to Monday, January 8, 2007.

B. Statement of the Facts

On June 12, 1991, Petitioners won $9,595,326.00 from the Pennsylvania Lottery which gave Petitioners the right to receive payments in the amount of $369,051 per year for 26 years. For approximately nine years, Petitioners received $367,051 each year from the Pennsylvania Lottery.

Petitioners did not have the option of receiving a lump sum payment from Pennsylvania when they won the lottery. The Pennsylvania Lottery purchased an annuity contract from Hartford Life Insurance Company to fund its annual obligation to the Petitioners. The Pennsylvania Lottery retained ownership of the Hartford Life Insurance Company annuity contract.

On August 12, 1999, Petitioners entered into a Sale Agreement with Singer Asset Finance Company to sell their rights to receive 17 of their future lottery payments. Pursuant to this agreement, Petitioners executed a "Terms Rider to Sale Agreement," which set forth the specific terms of the Sale Agreement and was incorporated into the Sale Agreement.

Petitioners were required by Pennsylvania law to obtain court approval prior to assigning their rights to future lottery payments. On August 27, 1999, the Commonwealth of

Pennsylvania Court of Common Pleas approved Petitioners' voluntary assignment of their lottery annuity to Singer.

September 2, 1999 was the closing date for the assignment of Petitioners' lottery annuity for the years 2000 through 2016, inclusive, and on September 8, 1999 during the taxable year 1999, Petitioners received $3,372,342 from Singer in exchange for the assignment of their lottery rights.

Singer issued Petitioners a Form 1099 for the 3,372,342 it paid to Petitioners. Petitioners reported the $3,372,342 they received from Singer for the sale of their future rights to lottery payments as long-term capital gain on Schedule D of their 1999 Federal income tax return.

Thereafter, Respondent determined that the $3,372,342 in proceeds Petitioners received from Singer, for the sale of their rights to future lottery payments, was ordinary income and issued a Notice of Deficiency.

REASONS FOR GRANTING THE PETITION

A. The court below – contrary to the clear statutory language of 26 U.S.C. § 1221 – erroneously determined that the sale of Petitioners' lottery right was not the sale of a capital asset and that the gain on the sale of the lottery right was ordinary income.

A capital gain occurs when a taxpayer sells a capital asset at a profit. *See* I.R.C. § 1222(3). Congress, in unambiguous language, has defined a capital asset as "property, held by the taxpayer (whether or not connected with his trade or business) . . ." subject to several statutory exclusions. I.R.C. § 1221(a). The lottery right associated with a winning

lottery ticket is property under federal law, *Estate of Gribauskas v. Commissioner*, 116 T.C. 12 (2001), *rev'd on other grounds*, 342 F.3d 85 (11th Cir. 2003), and it is not excluded from the definition of capital assets by any statutory exception. *See* I.R.C. § 1221(a).

I.R.C. §1223 sets forth the general statutory principles as to when income qualifies for long term capital gain treatment. Specifically, there is a three-part requirement: the gain must arise from (I) the sale or exchange of (ii) a capital asset that (iii) has been held by the taxpayer for more than one year. 26 U.S.C. § 1222(3). Petitioners held their lottery rights for more than one year before they sold them to Singer. Accordingly, the gain on that sale qualifies for long term capital gain treatment, provided that their right to receive the annuity payments is a capital asset. 26 U.S.C. § 1222(3).

Under the broad definition of capital assets set forth in section 1221, a lottery right held by a taxpayer constitutes a capital asset and the proceeds from the sale of the capital asset is a capital gain. Section 1221(a) sets forth a list of property rights excluded from consideration as capital assets.

In *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212, 222, 108 S.Ct. 971 (1988), this Court found that the list of exceptions to the definition of capital assets contained in section 1221 was exhaustive and expressly repudiated the I.R.S. Commissioner's contention that the courts were free to fashion additional exceptions to section 1221. In that case, this Court made clear that "[i]f a broad exclusion from capital-asset status is to be created . . . it must come from congressional action, not silence." *Id.* Accordingly, this Court rejected a judicially created test, which had no basis in the

statutory language and which the lower court used to exclude property otherwise considered a capital asset under section 1221. *Id.* at 216.

Notwithstanding the decision of this Court in *Arkansas Best Corp. v. Commissioner*, the lower court fashioned a hybrid test in order to fashion an additional exception to section 1221 and exclude Petitioners' lottery rights from capital asset status.[2] *See United States v. Lattera*, 437 F.3d 399 (3rd Cir. 2006). The hybrid test created by the lower court had no statutory basis in the statutory and was designed to narrow the broad statutory definition of property contained in section 1221, which the court recognized could include property not traditionally associated with capital gains treatment. *Id.* (citing *C.I.R. v. Gillette Motor Transp., Inc.*, 364 U.S. 130, 80 S.Ct. 1497 (1960)).

It is unmistakable that under the plain language of section 1221, Petitioners' lottery rights were a capital asset. *See United States v. Maginnis*, 353 F.3d at 1181 (noting that a literal reading of the statutory definition set forth in I.R.C. §§ 1221 and 1222 supported Petitioners' argument that the sale of the lottery right is in fact the sale of a capital asset). Despite this plain language, the lower court ignored the clear and unambiguous language of section 1221 and created an additional exclusion to section 1221. However, when the "language of a statute is clear, that language must be given

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2. The lower court applied part of the "substitute for ordinary income" doctrine, which says lump-sum consideration for future ordinary income may not be taxed as capital gain, *United States v. Maginnis*, 356 F.3d 1179, 1182 (9th Cir. 2004), and a version of the "family resemblance" test, in which the court looked to the "character of the asset" to determine whether it was like a capital asset or an income item.

effect . . . in absence of patent absurdity." *Immigration and Naturalization Service v. Cardoza-Fonseca,* 480 U.S. 421, 453 (1987). Moreover, language used in the Internal Revenue Code "should be interpreted when possible in their ordinary, everyday senses." *Crane v. Commissioner,* 331 U.S. 1, 6 (1947). Accordingly, this Court should reverse the lower court's decision and find that Petitioners' sale of their lottery rights was the sale of a capital asset as defined by section 1221 and that the income from the sale was capital gain.

B. Petitioners' lottery rights were a capital asset which produced capital gains upon sale, and the Substitute for Ordinary Income Doctrine does not preclude capital gain treatment.

Under the Uniform Commercial Code, the payment of a monetary obligation such as lottery winnings is an account receivable. UCC § 9-102(a)(2)(viii). Accounts receivable are specifically included in the definition of capital assets under I.R.C. §1221(a)(4).[3] The United States Tax Court has held that accounts receivable, upon sale, produce capital gains. *Hollingsworth v. Commissioner,* 71 T.C. 580 (1979). The sale of Petitioners' lottery rights was, in fact, the sale of a capital asset which produced capital gains. The lower court, however, erroneously concluded that the sale of the lottery right was not the sale of a capital asset but rather a sale of future ordinary income. As such, the lower court mistakenly found the gain to be ordinary gain.

The lower court found the gain to be ordinary after employing a hybrid form of the Substitute for Ordinary

3. Section 1221(a)(4) only excludes accounts receivable if they were acquired in the ordinary course of the taxpayer's business in exchange for personal services rendered or the sale of inventory.

Income Doctrine. However, it is well recognized that the sale proceeds of every asset are an economic substitute for future ordinary income and that under the faulty Substitute for Ordinary Income Doctrine, the sale of any asset could be characterized as ordinary income. *See e.g., United States v. Dresser Indus.,* 324 F2d 56, 58-59 (5th Cir. 1963). "[R]ead literally, the doctrine would completely swallow the concept of capital gains." Matthew S. Levine, *Lottery Winnings as Capital Gains,* 114 Yale Law Journal 195, 196 (2004). This Court should honor its holding in *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212,108 S.Ct. 971, and refuse to tacitly bless by denial of certiorari the judicially created test with no statutory basis in favor of adhering to the clear and unambiguous statutory definition of capital assets set forth by the legislature in I.R.C. § 1221(a). Accordingly, this Court should reverse the lower court's decision and find that Petitioners' lottery right was a capital asset under the plain language of section 1221 and that the sale of that capital asset produced capital gains.

C. The lower court's analysis is in conflict with the analysis employed by the courts in *Watkins v. Commissioner of Internal Revenue*, 447 F.3d 1269 (10th Cir. May 10, 2006) and *United States v. Maginnis*, 356 F.3d 1179 (9th Cir. 2004) and consideration by this Court is therefore necessary to secure and maintain uniformity among the circuits.

The Third Circuit's opinion affirming the United States Tax Court's decision that Petitioners' sale of the remaining payments of their lottery prize annuity was the sale of a non-capital asset properly subject to ordinary income treatment and not capital gain treatment is based on an imaginative and novel approach in conflict with the analysis traditionally

employed by courts when considering whether an asset is a capital asset.[4]

Traditionally, in this and similar settings, courts have analyzed transactions involving the sale of assets not specifically addressed in the relevant statute under what is known as the substitute-for-ordinary-income doctrine. This doctrine was first recognized by the United States Supreme Court in *Hort v. Commissioner*, 313 U.S. 28, 61 S.Ct. 757 (1941) in which the Supreme Court held that the cancellation of lease payments involved nothing more than the relinquishment of a right to future rental payments in return for the present substitute payment and possession of the lease premises. Hence, the Supreme Court ruled that the sale of the right to future rental payments constituted ordinary income and not the sale of a capital asset. *Id.* The Supreme Court re-employed the substitute-for-ordinary-income doctrine in several subsequent cases thereafter. *See e.g., Commissioner of Internal Revenue v. P.G. Lake, Inc*, 356 U.S. 260, 78 S.Ct. 691 (1958); *Commissioner v. Gillette Motor Company*, 364 U.S. 130, 80 S.Ct. 1497 (1960). However, the Supreme Court retracted from its expansive view of the substitute-for-ordinary-income doctrine in *Arkansas Best Corp v. Commissioner*, 485 U.S. 212, 108 S.Ct. 971.

A literal application of the statute defining capital assets requires that the sale of a lottery annuity be treated as the sale of a capital asset. In *Arkansas Best* this Court expressed

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4. As a simple proposition, the sale of a capital asset held for more than one year is taxed a capital gain rates, while the sale of a non-capital asset is taxed at ordinary income rates. I.R.C. § 1223, 26 U.S.C. § 1223. The definition of a capital asset is essentially any asset not specifically exempted from the definition. I.R.C. § 1221, 26 U.S.C. § 1221.

an unwillingness to read section 1221 of the Internal Revenue Code in a manner that renders a literal reading of the statute useless. *See Arkansas Best Corp. v. Commissioner*, 485 U.S. at 217-218. In addition, the substitute-for-ordinary-income doctrine as previously applied to lottery winning cases has been subject to academic criticism. *See e.g.,* Matthew S. Levin, Case Comment, *Lottery Winnings as Capital Gains*, 114 YALE L.J. 195, 197-202.

In an apparent effort to avoid the well known pitfalls of the substitute-for-ordinary-income doctrine, the lower court fashioned a novel approach referred to as the "family resemblance test." *See Latterra v. Commissioner*, 437 F.3d 399, 406-410. The panel's application of the "family resemblance test," although a perhaps more intellectually honest than the attempt to apply the *Hort-Lake* line of cases to the issue of concern, represents a level of statutory interpretation which courts should be loathe to employ. "[C]ourts are not authorized to rewrite statutes because they might deem its effects susceptible to improvement." *Badaracco v. Commissioner of Internal Revenue*, 464 U.S. 386, 398, 104 S.Ct. 756, 764 (1984). As the Eleventh Circuit Court of Appeals has recognized, "if there are problems with the way a statute operates, Congress can alter the statute to eliminate those problems [and courts cannot]. Only judicial activists use interpretation as a tool for improving statutes to their liking. . . ." *In re Bracewell* 454 F.3d 1234 (11th Cir. 2006). By reading a family resemblance analysis into the clear definitional exclusion contained in I.R.C. §1221, the lower court essentially crossed the line into legislative policymaking rather than limited statutory interpretation.

In addition, the analysis employed by the lower court represented a marked deviation from the analysis employed

by two of the court's sister circuits in addressing the identical issue. For example, in *United States v. Maginnis*, 356 F.3d 1179, the court interpreted the *Hort/Lake* substitute-for-ordinary-income doctrine as dictating ordinary income treatment for the sale of lottery winnings. *Maginnis* was criticized not only by academics but also by the Third Circuit in that panel's decision in the current matter.

After the panel issued its opinion in this case, the Tenth Circuit Court of Appeals issued its decision in *Watkins v. Commissioner*, 447 F.3d 1269 (10th Cir. May 10, 2006) in which the court recognized the different analyses employed by the Third Circuit and the court in *Maginnis* and declined to "enter the fray." *Id* at 1273. Instead, the *Watkins* court simply concluded that there is "no question that [taxpayer's] exchange for a lump sum payment was his future right to receive set amounts of income he had essentially already obtained as a result of his lottery success. Application of the substitute-for-ordinary-income doctrine is therefore entirely proper [in taxpayer's] case." *Id.*

It is imperative that this Court grant a writ of certiorari to consider the lower courts decision so as to address the competing views employed by other courts and to correct their efforts to read into the statutory language treatment of a transaction that is inconsistent with the plain language of the statute.

CONCLUSION

For all of the above reasons, petitioner requests that this Court issue a writ of certiorari in this matter.

Respectfully submitted,

MARK E. CEDRONE
CEDRONE & JANOVE
Suite 940 Public Ledger Building
150 South Independence Mall West
6th and Chestnut Streets
Philadelphia, Pennsylvania 19106
(215) 925-2500

Attorneys for Petitioners

APPENDIX

APPENDIX A — OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT FILED FEBRUARY 14, 2006

UNITED STATES COURT OF APPEALS
THIRD CIRCUIT

No. 04-4721.

Argued Jan. 9, 2006.
Filed Feb. 14, 2006.
As Amended April 5, 2006.

George **LATTERA**; Angeline **Lattera**,

Appellants

v.

COMMISSIONER OF INTERNAL REVENUE.

Before BARRY and AMBRO, Circuit Judges, and DEBEVOISE,* District Judge.

AMBRO, Circuit Judge.

Lottery winners, after receiving several annual installments of their lottery prize, sold for a lump sum the right to their remaining payments. They reported their sale proceeds as capital gains on their tax return, but the Internal Revenue Service (IRS) classified those proceeds as ordinary

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* Honorable Dickinson R. Debevoise, Senior District Court Judge for the District of New Jersey, sitting by designation.

income. The substitute-for-ordinary-income doctrine holds that lump-sum consideration substituting for something that would otherwise be received at a future time as ordinary income should be taxed the same way. We agree with the Commissioner of the IRS that the lump-sum consideration paid for the right to lottery payments is ordinary income.

I. Factual Background and Procedural History

In June 1991 George and Angeline Lattera turned a one-dollar lottery ticket into $9,595,326 in the Pennsylvania Lottery. They did not then have the option to take the prize in a single lump-sum payment, so they were entitled to 26 annual installments of $369,051.

In September 1999 the Latteras sold their rights to the 17 remaining lottery payments to Singer Asset Finance Co., LLC for $3,372,342. Under Pennsylvania law, the Latteras had to obtain court approval before they could transfer their rights to future lottery payments, and they did so in August 1999.

On their joint tax return, the Latteras reported this sale as the sale of a capital asset held for more than one year. They reported a sale price of $3,372,342, a cost or other basis of zero, and a long-term capital gain of the full sale price. The Commissioner determined that this sale price was ordinary income. In December 2002 the Latteras were sent a notice of deficiency of $660,784.[1]

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1. The parties' stipulation of facts states this number as $660,748, but the notice of deficiency reads $660,784.

Appendix A

In March 2003 the Latteras petitioned the Tax Court for a redetermination of the deficiency. The Court held in favor of the Commissioner. The Latteras now appeal to our Court.

II. Jurisdiction and Standard of Review

The Tax Court had subject matter jurisdiction under I.R.C. § 7442. Because its decision was final, we have appellate jurisdiction under I.R.C. § 7482(a)(1). The Latteras reside in our Circuit, so venue is proper under I.R.C. § 7482(b)(1)(A).

We review the Tax Court's legal determinations *de novo*, but we do not disturb its factual findings unless they are clearly erroneous. *Estate of Meriano v. Comm'r*, 142 F.3d 651, 657 (3d Cir.1998).

III. Discussion

The lottery payments the Latteras had a right to receive were gambling winnings, and the parties agree that the annual payments were ordinary income. *Cf. Comm'r v. Groetzinger*, 480 U.S. 23, 32 n. 11, 107 S.Ct. 980, 94 L.Ed.2d 25 (1987) (calling a state lottery "public gambling" in a case treating gambling winnings as ordinary income). But the Latteras argue that, when they sold the right to their remaining lottery payments, the sale gave rise to a long-term capital gain.

Whether the sale of a right to lottery payments by a lottery winner can be treated as a capital gain under the Internal Revenue Code is one of first impression in our Circuit. But it is not a new question. Both the Tax Court and the Ninth

Circuit Court of Appeals have held that such sales deserve ordinary-income treatment. *United States v. Maginnis*, 356 F.3d 1179, 1181 (9th Cir.2004) ("Fundamental principles of tax law lead us to conclude that [the] assignment of [a] lottery right produced ordinary income."); *Davis v. Comm'r*, 119 T.C. 1, 1, 2002 WL 1446631 (2002); *see also Watkins v. Comm'r*, 88 T.C.M. (CCH) 390, 393 (2004); *Clopton v. Comm'r*, 87 T.C.M. (CCH) 1217, 1217 (2004); *Boehme v. Comm'r*, 85 T.C.M. (CCH) 1039, 1041 (2003).

The Ninth Circuit's reasoning has drawn significant criticism, however. *See* Matthew S. Levine, Case Comment, *Lottery Winnings as Capital Gains*, 114 Yale L.J. 195, 197-202 (2004); Thomas G. Sinclair, Comment, *Limiting the Substitute-for-Ordinary Income Doctrine: An Analysis Through Its Most Recent Application Involving the Sale of Future Lottery Rights*, 56 S.C. L.Rev. 387, 421-22 (2004). In this context, we propose a different approach. We begin with a discussion of basic concepts that underlie our reasoning.

A. Definition of a capital asset

A long-term capital gain (or loss) is created by the "sale or exchange of a capital asset held for more than 1 year." I.R.C. § 1222(3). Section 1221 of the Internal Revenue Code defines a capital asset as "property held by the taxpayer (whether or not connected with his trade or business)." This

provision excludes from the definition certain property categories, none of which is applicable here.[2]

A 1960 Supreme Court decision suggested that this definition can be construed too broadly, stating that "it is evident that not everything which can be called property in the ordinary sense and which is outside the statutory exclusions qualifies as a capital asset." *Comm'r v. Gillette Motor Transp., Inc.*, 364 U.S. 130, 134, 80 S.Ct. 1497, 4 L.Ed.2d 1617 (1960). The Court noted that it had "long held that the term 'capital asset' is to be construed narrowly in accordance with the purpose of Congress to afford capital-gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time, and thus to ameliorate the hardship of taxation of the entire gain in one year." *Id.* But the Supreme Court's decision in *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212, 108 S.Ct. 971, 99 L.Ed.2d 183 (1988), at least at first blush, seems to have reversed that narrow reading. *Arkansas Best* suggests instead that the capital-asset definition is to

2. Section § 1221, as it read when the Latteras sold their lottery rights, contained five exceptions (stock in trade of the taxpayer, depreciable trade or business property, copyrights, accounts receivable acquired in the ordinary course of trade or business, and Government publications). The provision was amended in December 1999 to exclude also commodities derivative financial instruments held by dealers, hedging transactions, and supplies used or consumed in trade or business. Tax Relief Extension Act of 1999, Pub.L. No. 106-170, tit. V, § 532(a), 113 Stat. 1860, 1928-30. These exclusions are not applicable to this case; the amendments did not apply to transactions entered into before December 17, 1999, *see id.* § 532(d), 113 Stat. at 1931, and the Latteras sold their lottery rights in September 1999.

be broadly construed. *See id.* at 218, 108 S.Ct. 971 ("The body of § 1221 establishes a general definition of the term 'capital asset,' and the phrase 'does not include' takes out of that broad definition only the classes of property that are specifically mentioned.").

B. The substitute-for-ordinary-income doctrine

The problem with an overly broad definition for capital assets is that it could "encompass some things Congress did not intend to be taxed as capital gains." *Maginnis*, 356 F.3d at 1181. An overly broad definition, linked with favorable capital-gains tax treatment, would encourage transactions designed to convert ordinary income into capital gains. *See id.* at 1182. For example, a salary is taxed as ordinary income, and the right to be paid for work is a person's property. But it is hard to conceive that Congress intends for taxpayers to get capital-gains treatment if they were to sell their rights (*i.e.*, "property held by the taxpayer") to their future paychecks. *See* 2 Boris I. Bittker & Lawrence Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 47.1 (3d ed.2000).

To get around this problem, courts have created the substitute-for-ordinary-income doctrine. This doctrine says, in effect, that " 'lump sum consideration [that] seems essentially a substitute for what would otherwise be received at a future time as ordinary income' may not be taxed as a capital gain." *Maginnis*, 356 F.3d at 1182 (quoting *Comm'r v. P.G. Lake, Inc.*, 356 U.S. 260, 265, 78 S.Ct. 691, 2 L.Ed.2d 743 (1958)) (alteration in original).

Appendix A

The seminal substitute-for-ordinary-income case is the 1941 Supreme Court decision in *Hort v. Commissioner*, 313 U.S. 28, 61 S.Ct. 757, 85 L.Ed. 1168 (1941). Hort had inherited a building from his father, and one of the building's tenants canceled its lease, paying Hort a cancellation fee of $140,000. *Id.* at 29, 61 S.Ct. 757. Hort argued that the cancellation fee was capital gain, but the Court disagreed, holding that the cancellation fee was ordinary income because the "cancellation of the lease involved nothing more than relinquishment of the right to future rental payments in return for a present substitute payment and possession of the leased premises." *Id.* at 32, 61 S.Ct. 757.

The Supreme Court bolstered the doctrine in *Lake*. P.G. Lake, Inc. was an oil- and gas-producing company with a working interest in two oil and gas leases. 356 U.S. at 261-62, 78 S.Ct. 691. It assigned an oil payment right "payable out of 25 percent of the oil attributable to [Lake's] working interest in the two leases." *Id.* at 262, 78 S.Ct. 691. Lake reported this assignment as a sale of property taxable as capital gain. *Id.* But the Court disagreed, holding that the consideration received was taxable as ordinary income. *Id.* at 264, 78 S.Ct. 691. The Court's reasoning gave full voice to the substitute-for-ordinary-income doctrine: "The lump sum consideration seems essentially a substitute for what would otherwise be received at a future time as ordinary income." *Id.* at 265, 78 S.Ct. 691.

Our Court has rarely dealt with this doctrine. We have only cited *Lake* twice-once in 1958, *Tunnell v. United States*, 259 F.2d 916, 918 (3d Cir.1958), and once in 1974, *Hempt Bros., Inc. v. United States*, 490 F.2d 1172, 1176, 1178 (3d

Cir.1974) (citing *Lake* with approval, but deciding the case under a § 351-nonrecognition of transfers of property for corporate stock-analysis).

The Latteras argue that the substitute-for-ordinary-income doctrine, which takes "property held by the taxpayer" outside the statutory capital-asset definition, did not survive *Arkansas Best.* But although *Arkansas Best* ostensibly cabined the exceptions to the statutory definition, it made clear that the *Hort-Lake* "line of cases, based on the premise that § 1221 'property' does not include claims or rights to ordinary income, ha[d] no application in the present context." *Arkansas Best*, 485 U.S. at 217 n. 5, 108 S.Ct. 971. The Tax Court has several times confirmed that *Arkansas Best* "in no way affected the viability of the principle established in the [*Hort-Lake*] line of cases." *Davis*, 119 T.C. at 6 (citing cases). And the Ninth Circuit agrees. *Maginnis*, 356 F.3d at 1185. We follow suit, holding that the substitute-for-ordinary-income doctrine remains viable in the wake of *Arkansas Best.*

But there is a tension in the doctrine: in theory, all capital assets are substitutes for ordinary income. *See, e.g.*, William A. Klein *et al.*, *Federal Income Taxation* 786 (12th ed. 2000) ("A fundamental principle of economics is that the value of an asset is equal to the present discounted value of all the expected net receipts from that asset over its life."); *see also Lake*, 356 U.S. at 266, 78 S.Ct. 691 (noting that the lump-sum consideration-held to be ordinary income-paid for an asset was "the present value of income which the recipient would otherwise obtain in the future"). For example, a stock's value is the present discounted value of the company's future profits. *See, e.g.*, *Maginnis*, 356 F.3d at 1182; *cf. United*

States v. Dresser Indus., Inc., 324 F.2d 56, 59 (5th Cir.1963) (applying this concept to the value of land). "[R]ead literally, the [substitute-for-ordinary-income] doctrine would completely swallow the concept of capital gains." Levine, *supra*, at 196; *accord* 2 Bittker & Lokken, *supra*, ¶ 47.9.5, at 47-68 ("Unless restrained, the substitute-for-ordinary-income theory thus threatens even the most familiar capital gain transactions."). Also, an "overbroad 'substitute for ordinary income' doctrine, besides being analytically unsatisfactory, would create the potential for the abuse of treating capital losses as ordinary."[3] Levine, *supra*, at 197. The doctrine must therefore be limited so as not to err on either side.

C. The lottery cases

Even before the Ninth Circuit decided *Maginnis*, the Tax Court had correctly answered the question of whether sales of lottery winnings were capital gains. In *Davis v. Commissioner*, lottery winners had sold their rights to 11 of their total 14 future lottery payments for a lump sum. 119 T.C. at 3. The Tax Court found that the lump-sum payment to the lottery winners was the "discounted value . . . of certain ordinary income which they otherwise would have received during the years 1997 through 2007." *Id.* at 7. The Court held, therefore, that (1) the purchaser of the lottery payment rights paid money for "the right to receive . . . future ordinary income, and not for an increase in the value of income-producing property"; (2) the lottery winners' right to their future lottery payments was not a capital asset; and (3) the

3. Note that our holding in this case does not consider the substitute-for-ordinary-income doctrine in loss transactions.

lump-sum payment was to be taxed as ordinary income. *Id.; see also Watkins*, 88 T.C.M. (CCH) at 393 (following *Davis*, in a post- *Maginnis* decision); *Clopton*, 87 T.C.M. (CCH) at 1219 (citing Tax Court cases following *Davis*).

In 2004 the Ninth Circuit decided *Maginnis*, the first (and so far only) appellate opinion to deal with this question. Maginnis won $9 million in a lottery and, after receiving five of his lottery payments, assigned all of his remaining future lottery payments to a third party for a lump-sum payment of $3,950,000. *Maginnis*, 356 F.3d at 1180. The Ninth Circuit held that Maginnis's right to future lottery payments was not a capital asset and that the lump-sum payment was to be taxed as ordinary income. *Id.* at 1182.

The Court relied on the substitute-for-ordinary-income doctrine, but it was concerned about taking an "approach that could potentially convert all capital gains into ordinary income [or] one that could convert all ordinary income into capital gains." *Id.* The Court opted instead for "case-by-case judgments as to whether the conversion of income rights into lump-sum payments reflects the sale of a capital asset that produces a capital gain, or whether it produces ordinary income." *Id.* It set out two factors, which it characterized as "crucial to [its] conclusion," but not "dispositive in all cases": "Maginnis (1) did not make any underlying investment of capital in return for the receipt of his lottery right, and (2) the sale of his right did not reflect an accretion in value over cost to any underlying asset Maginnis held." *Id.* at 1183.

But two commentators have criticized the analysis in *Maginnis*, especially the two factors. *See* Levine, *supra*, at

197-202; Sinclair, *supra*, at 421-22. The first factor-underlying investment of capital-would theoretically subject all inherited and gifted property (which involves no investment at all) to ordinary-income treatment. *See* Levine, *supra*, at 198. It also does not explain the result in *Lake*, where the company presumably made an investment in its working interest in oil and gas leases, yet the Supreme Court applied ordinary-income treatment. *Id.*

The second factor also presents analytical problems. Not all capital assets experience an accretion in value over cost. For example, cars typically depreciate, but they are often capital assets. *See* Sinclair, *supra*, at 421. Levine criticizes the second factor for "attempt[ing] to determine the character of a gain from its amount." Levine, *supra*, at 199. The *Maginnis* Court held that there was no accretion of value over cost in lottery winnings because there was no cost, as "Maginnis did not make any capital investment in exchange for his lottery right." 356 F.3d at 1184. But if Maginnis's purchase of a lottery ticket had been a capital investment, would the second factor automatically have been satisfied? (That is, the "cost" in that scenario would have been $1, and the increase would have been $3,949,999.) Our first instinct is no. Moreover, the second factor does not seem to predict correctly the result in both *Hort* (where a building was inherited for no "cost") and *Lake* (where the working interest in the oil lease presumably had a "cost"), in both of which the taxpayer got ordinary-income treatment.

Thus, while we agree with *Maginnis'* s result, we do not simply adopt its reasoning. And it is both unsatisfying and unhelpful to future litigants to declare that we know this to

be ordinary income when we see it. The problem is that, "[u]nless and until Congress establishes an arbitrary line on the otherwise seamless spectrum between *Hort-Lake* transactions and conventional capital gain transactions, the courts must locate the boundary case by case, a process that can yield few useful generalizations because there are so many relevant but imponderable criteria." 2 Bittker & Lokken, *supra*, ¶ 47.9.5, at 47-69 (footnote omitted).

We therefore proceed to our case-by-case analysis, but in doing so we set out a method for analysis that guides our result. At the same time, however, we recognize that any rule we create could not account for every contemplated transactional variation.

D. Substitute-for-ordinary-income analysis

In our attempt to craft a rubric, we find helpful a Second Circuit securities case and a recent student comment. The Second Circuit dealt with a similarly "seamless spectrum" in 1976 when it needed to decide whether a note was a security for purposes of section 10(b) of the 1934 Securities and Exchange Act. *See Exch. Nat'l Bank of Chi. v. Touche Ross & Co.*, 544 F.2d 1126, 1138 (2d Cir.1976). The Court created a "family resemblance" test, (1) presuming that notes of more than nine months' maturity were securities, (2) listing various types of those notes that it did not consider securities, and (3) declaring that a note with maturity exceeding nine months that "does not bear a strong family resemblance to these examples" was a security. *Id.* at 1138, 1137-38. The Supreme Court, adopting this test in 1990, added four factors to guide the "resemblance" analysis: the motivations of the

buyers and sellers, the plan of distribution, the public's reasonable expectations, and applicable risk-reducing regulatory schemes. *Reves v. Ernst & Young*, 494 U.S. 56, 65-67, 110 S.Ct. 945, 108 L.Ed.2d 47 (1990).

We adopt an analogous analysis. Several types of assets we know to be capital: stocks, bonds, options, and currency contracts, for example. *See, e.g., Arkansas Best*, 485 U.S. at 222-23, 108 S.Ct. 971 (holding-even though, as noted above, the value of a stock is really the present discounted value of the company's future profits-that "stock is most naturally viewed as a capital asset"); *see also id.* at 217 n. 5, 108 S.Ct. 971 (distinguishing "capital stock" from "a claim to ordinary income"); *Simpson v. Comm'r*, 85 T.C.M. (CCH) 1421, 1423 n. 7 (2003) (distinguishing "currency contracts, stocks, bonds, and options" from a right to receive lottery payments). We could also include in this category physical assets like land and automobiles.

Similarly, there are several types of rights that we know to be ordinary income, *e.g.*, rental income and interest income. In *Gillette Motor*, the Supreme Court held that ordinary-income treatment was indicated for the right to use another's property-rent, in other words. *See* 364 U.S. at 135, 80 S.Ct. 1497. Similarly, in *Midland-Ross*, the Supreme Court held that earned original issue discount should be taxed as ordinary income. *See United States v. Midland-Ross Corp.*, 381 U.S. 54, 58, 85 S.Ct. 1308, 14 L.Ed.2d 214 (1965). There, the taxpayer purchased non-interest-bearing notes at a discount from the face amount and sold them for more than their issue price (but still less than the face amount). *Id.* at 55, 85 S.Ct. 1308. This gain was conceded to be equivalent

to interest, and the Court held it taxable as ordinary income. *Id.* at 55-56, 58, 85 S.Ct. 1308.

For the "family resemblance" test, we can set those two categories at the opposite poles of our analysis. For example, we presume that stock, and things that look and act like stock, will receive capital-gains treatment. For the in-between transactions that do not bear a family resemblance to the items in either category, like contracts and payment rights, we use two factors to assist in our analysis: (1) type of "carve-out" and (2) character of asset.[4]

1. *Type of carve-out*

The notion of the carve-out, or partial sale, has significant explanatory power in the context of the *Hort-Lake* line of cases. As Marvin Chirelstein writes, the " 'substitute' language, in the view of most commentators, was merely a short-hand way of asserting that carved-out interests do not qualify as capital assets." Marvin A. Chirelstein, *Federal Income Taxation* ¶ 17.03, at 369-70 (9th ed.2002).

There are two ways of carving out interests from property: horizontally and vertically. A horizontal carve-out is one in which "temporal divisions [are made] in a property interest in which the person owning the interest disposes of part of his interest but also retains a portion of it." Sinclair, *supra*, at 401. In lottery terms, this is what happened in *Davis*,

4. We borrow these factors from Thomas Sinclair's comment, *see* Sinclair, *supra*, at 401-03, but we differ from him slightly in the way we apply the character factor.

Boehme, and *Clopton*-the lottery winners sold some of their future lottery payment rights (*e.g.*, their 2006 and 2007 payments) but retained the rights to payments further in the future (*e.g.*, their 2008 and 2009 payments). *See Clopton*, 87 T.C.M. (CCH) at 1217-18 (finding that the lottery winner sold only some of his remaining lottery payments); *Boehme*, 85 T.C.M. (CCH) at 1040 (same); *Davis*, 119 T.C. at 3 (same). This is also what happened in *Hort* and *Lake;* portions of the total interest (a term of years carved out from a fee simple and a three-year payment right from a working interest in a oil lease, respectively) were carved out from the whole.

A vertical carve-out is one in which "a complete disposition of a person's interest in property" is made. Sinclair, *supra*, at 401. In lottery terms, this is what happened in *Watkins* and *Maginnis*-the lottery winners sold the rights to all their remaining lottery payments. *See Maginnis*, 356 F.3d at 1181 (noting that the lottery winner assigned his right to receive all his remaining lottery payments); *Watkins*, 88 T.C.M. (CCH) at 391 (same).

Horizontal carve-outs typically lead to ordinary-income treatment. *See, e.g., Maginnis*, 356 F.3d at 1185-86 ("Maginnis is correct that transactions in which a tax-payer transfers an income right without transferring his entire interest in an underlying asset will often be occasions for applying the substitute for ordinary income doctrine."). This was also the result reached in *Hort* and *Lake. Lake*, 356 U.S. at 264, 78 S.Ct. 691; *Hort*, 313 U.S. at 32, 61 S.Ct. 757.

Vertical carve-outs are different. In *Dresser Industries*, for example, the Fifth Circuit distinguished *Lake* because

the taxpayer in *Dresser* had "cut [ ] off a 'vertical slice' of its rights, rather than carv[ed] out an interest from the totality of its rights." *Dresser Indus.*, 324 F.2d at 58. But as the results in *Maginnis* and *Watkins* demonstrate, a vertical carve-out does not necessarily mean that the transaction receives capital-gains treatment. *See, e.g.*, *Maginnis*, 356 F.3d at 1185 (holding "that a transaction in which a taxpayer sells his entire interest in an underlying asset without retaining any property right does not *automatically* prevent application of the substitute for ordinary income doctrine" (emphasis in original)); *see also id.* at 1186.

Because a vertical carve-out could signal either capital-gains or ordinary-income treatment, we must make another determination to conclude with certainty which treatment should apply. Therefore, when we see a vertical carve-out, we proceed to the second factor-character of the asset-to determine whether the sale proceeds should be taxed as ordinary income or capital gain.

2. *Character of the asset*

The Fifth Circuit in *Dresser Industries* noted that "[t]here is, in law and fact, a vast difference between the present sale of the future right to *earn* income and the present sale of the future right to *earned* income." *Dresser Indus.*, 324 F.2d at 59 (emphasis in original). The taxpayer in *Dresser Industries* had assigned its right to an exclusive patent license back to the patent holder in exchange for a share of the licensing fees from third-party licensees. *Id.* at 57. The Court used this "right to earn income"/"right to earned income" distinction to hold that capital-gains treatment was

applicable. It noted that the asset sold was not a "right to earned income, to be paid in the future," but was "a property which would produce income." *Id.* at 59. Further, it disregarded the ordinary nature of the income generated by the asset; because "all income-producing property" produces ordinary income, the sale of such property does not result in ordinary-income treatment. *Id.* (This can be seen in the sale of bonds, which produce ordinary income, but the sale of which is treated as capital gain.)

Sinclair explains the distinction in this way: "Earned income conveys the concept that the income has already been earned and the holder of the right to this income only has to collect it. In other words, the owner of the right to earned income is entitled to the income merely by virtue of owning the property." Sinclair, *supra*, at 406. He gives as examples of this concept rental income, stock dividends, and rights to future lottery payments. *Id.* (Of course, in the wake of dividend tax reform, stock dividends are now taxed as capital gains. I.R.C. § 1(h)(11).) For the right to earn income, on the other hand, "the holder of such right must do something further to earn the income. . . . [because] mere ownership of the right to earn income does not entitle the owner to income." Sinclair, *supra*, at 406. Following *Dresser Industries*, Sinclair gives a patent as an example of this concept. *Id.*

Assets that constitute a right to earn income merit capital-gains treatment, while those that are a right to earned income merit ordinary-income treatment. Our Court implicitly made this distinction in *Tunnell v. United States*, 259 F.2d 916 (3d Cir.1958). Tunnell withdrew from a law partnership, and he assigned his rights in the law firm in exchange for $27,500.

Id. at 917. When he withdrew, the partnership had over $21,000 in uncollected accounts receivable from work that had already been done. *Id.* We agreed with the District Court that "the sale of a partnership is treated as the sale of a capital asset." *Id.* The sale of a partnership does not, in and of itself, confer income on the buyer; the buyer must continue to provide legal services, so it is a sale of the right to *earn* income. Consequently, as we held, the sale of a partnership receives capital-gains treatment. The accounts receivable, on the other hand, had already been earned; the buyer of the partnership only had to remain a partner to collect that income, so the sale of accounts receivable is the sale of the right to *earned* income. Thus, we held that the portion of the purchase price that reflected the sale of the accounts receivable was taxable as ordinary income. *Id.* at 919.

Similarly, when an erstwhile employee is paid a termination fee for a personal-services contract, that employee still possesses the asset (the right to provide certain personal services) and the money (the termination fee) has already been "earned" and will simply be paid. The employee no longer has to perform any more services in exchange for the fee, so this is not like *Dresser Industries'* s "right to earn income." These termination fees are therefore rights to earned income and should be treated as ordinary income. *See, e.g., Elliott v. United States*, 431 F.2d 1149, 1154 (10th Cir.1970); *Holt v. Comm'r*, 303 F.2d 687, 690 (9th Cir.1962); *see also* Chirelstein, *supra*, ¶ 17.03, at 376-77 (noting that "courts have held consistently that payments made to an employee for the surrender of his employment contract are ordinary").

The factor also explains, for example, the Second Circuit's complex decision in *Commissioner v. Ferrer*, 304 F.2d 125 (2d Cir.1962). The actor José Ferrer had contracted for the rights to mount a stage production based on the novel *Moulin Rouge*. *Id.* at 126. In the contract, Ferrer obtained two rights relevant here: (1) the exclusive right to "produce and present" a stage production of the book and, if the play was produced, (2) a share in the proceeds from any motion-picture rights that stemmed from the book. *Id.* at 127. After a movie studio planned to make *Moulin Rouge* into a movie-and agreed that it would feature Ferrer-he sold these, along with other, rights. *Id.* at 128-29. Right (1) would have required Ferrer to have produced and presented the play to get income, so it was a right to earn income-thus, capital-gains treatment was indicated. Right (2), once it matured (*i.e.*, once Ferrer had produced the play), would have continued to pay income simply by virtue of Ferrer's holding the right, so it would have become a right to earned income-thus, ordinary-income treatment was indicated. The Second Circuit held as such, dictating capital-gains treatment for right (1) and ordinary-income treatment for right (2). *Id.* at 131, 134.[5]

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5. One well-known result that these factors do not predict is the Second Circuit's 1946 opinion in *McAllister v. Commissioner*, 157 F.2d 235 (2d Cir.1946). In that case, a widow was forced to sell her life estate in a trust to the remainderman. *Id.* at 235. Thus, she received a lump-sum payment in exchange for her right to all future payments from the trust. Although this was a vertical carve-out, susceptible to both types of treatment, she gave up her right to *earned* income, because she would have continued receiving payments simply by holding the life estate. Thus, the sale proceeds should

(Cont'd)

Appendix A

E. Application of the "family resemblance" test

Applied to this case, the "family resemblance" test draws out as follows. First, we try to determine whether an asset is like either the "capital asset" category of assets (*e.g.*, stocks, bonds, or land) or like the "income items" category (*e.g.*, rental income or interest income). If the asset does not bear a family resemblance to items in either of those categories, we move to the following factors.

We look at the nature of the sale. If the sale or assignment constitutes a horizontal carve-out, then ordinary-income treatment presumably applies. If, on the other hand, it constitutes a vertical carve-out, then we look to the character-of-the-asset factor. There, if the sale is a lump-sum payment

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(Cont'd)

have received ordinary-income treatment. The Court held instead that capital-gains treatment was indicated. *Id.* at 236.

But the result in *McAllister* has been roundly criticized. The Tax Court in that case had held that ordinary-income treatment was proper, *id.* at 235, and Judge Frank entered a strong dissent, *id.* at 237-41 (Frank, J., dissenting). The *McAllister* Court relied on a case that did not even discuss the capital-asset statute. *Id.* at 237 (majority opinion). Chirelstein writes that the "decision in *McAllister* almost certainly was wrong." Chirelstein, *supra*, ¶ 17.03, at 373. And a 2004 Tax Court opinion did not even bother to distinguish *McAllister*, stating simply that it was "decided before relevant Supreme Court decisions applying the substitute for ordinary income doctrine" (referring, *inter alia*, to *Lake*). *Clopton*, 87 T.C.M. (CCH) at 1219.

We consider *McAllister* to be an aberration, and we do not find it persuasive in our decision in this case.

for a future right to *earned* income, we apply ordinary-income treatment, but if it is a lump-sum payment for a future right to *earn* income, we apply capital-gains treatment.

Turning back to the Latteras, the right to receive annual lottery payments does not bear a strong family resemblance to either the "capital assets" or the "income items" listed at the polar ends of the analytical spectrum. The Latteras sold their right to all their remaining lottery payments, so this is a vertical carve-out, which could indicate either capital-gains or ordinary-income treatment. But because a right to lottery payments is a right to earned income (*i.e.*, the payments will keep arriving due simply to ownership of the asset), the lump-sum payment received by the Latteras should receive ordinary-income treatment.

This result comports with *Davis* and *Maginnis*. It also ensures that the Latteras do not "receive a tax advantage as compared to those taxpayers who would simply choose originally to accept their lottery winning in the form of a lump sum payment," something that was also important to the *Maginnis* Court. *Maginnis*, 356 F.3d at 1184.[6]

6. We do not decide whether Singer, who purchased the right to lottery payments from the Latteras, would receive ordinary income or capital gain if it later decided to sell that right to another third party. *See Maginnis*, 356 F.3d at 1183 n. 4. Such a determination would need to be made on the specific facts of the transaction. For example, if Singer bought and sold such rights as part of its business, the lottery payment rights could theoretically fall under the inventory exclusion to the capital-asset definition. *Cf. Arkansas Best*, 485 U.S. at 222, 108 S.Ct. 971 (suggesting that if Arkansas Best had been a dealer in securities, its bank stock might have fallen within § 1221's inventory exclusion).

Appendix A

IV. Conclusion

The lump-sum consideration paid to the Latteras in exchange for the right to their future lottery payments is ordinary income.[7] We therefore affirm.

7. The Latteras appear to argue that their lottery ticket was itself a capital asset. We do not need to address this issue, as we note that the Latteras did not sell their winning ticket to Singer. Instead, they relinquished it in 1991 to the Pennsylvania State Lottery so they could claim their prize. They sold Singer eight years later not the physical lottery ticket but their right to the annual lottery payments.

APPENDIX B — MEMORANDUM OPINION AND ORDER OF THE UNITED STATES TAX COURT FILED AND ENTERED SEPTEMBER 23, 2004

UNITED STATES TAX COURT

GEORGE AND ANGELINE LATTERA,

Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

Docket No. 4269-03. Filed September 23, 2004.

MEMORANDUM OPINION

VASQUEZ, *Judge*: Respondent determined a deficiency of $660,784 in petitioners' 1999 Federal income tax.[1] The sole issue for decision is whether a lump-sum payment received in exchange for the assignment of the right to receive future annual lottery payments is ordinary income or capital gain.

Background

The parties submitted this case fully stipulated pursuant to Rule 122.[2] The stipulation of facts and the attached exhibits

1. All amounts are rounded to the nearest dollar.

2. Unless otherwise indicated, all Rule references are to the Tax Court Rules of Practice and Procedure, and all section references are to the Internal Revenue Code in effect for the year in issue.

are incorporated herein by this reference. At the time they filed their petition, petitioners resided in Philadelphia, Pennsylvania.

On June 12, 1991, petitioners won $9,595,326 from the Pennsylvania Lottery. Petitioners did not have the option of receiving the prize in a single lump-sum payment. The prize was payable in 26 annual installments of $369,051. Petitioners purchased the winning lottery ticket for $1.

On August 12, 1999, petitioners and Singer Asset Finance Co., L.L .C. (Singer) entered into a "Sale Agreement for Lottery Prize Payments of George M. Lattera and Angeline Lattera" and "Terms Rider to Sale Agreement for Lottery Prize Payments of George M. Lattera and Angeline Lattera" (the sale agreements), that assigned petitioners' rights, title, and interest in the lottery prize to Singer. Under the terms of the sale agreements, the remaining 17 annual payments of $369,051, payable on or about June 12, 2000 through 2016, were sold to Singer for $3,372,342.

Under Pennsylvania State law, petitioners were required to obtain court approval before they could transfer their rights to receive future lottery payments. On August 27, 1999, petitioners obtained the requisite approval from the Court of Common Pleas of Dauphin County.

Singer issued petitioners a Form 1099-B, Proceeds From Broker and Barter Exchange Transactions, for 1999. The Form 1099-B listed proceeds from the sale of "Stocks, bonds, etc." of $3.372.342.

Appendix B

Petitioners jointly filed a Form 1040, U.S. Individua Income Tax Return, for 1999. On Schedule D, Capital Gain and Losses, petitioners reported the assignment of the 1' future annual lottery payments of $369,051 to Singer as sale of a capital asset held for more than 1 year. Petitioner reported a sale price of $3,372,342, a cost or other basis c zero,[3] and a long-term capital gain of $3,372,342.

Respondent issued a notice of deficiency to petitioner for 1999. In the notice of deficiency, respondent determine that the $3,372,342 received from Singer was ordinar income.

Discussion

The issue is whether the $3,372,342 petitioners receive from Singer for the assignment of future lottery payments i ordinary income or capital gain. Resolution of the issu depends on whether the right to receive future annual lotter payments constitutes a capital asset.

Section 1221 defines "capital asset" as follows:

> SEC. 1221. CAPITAL ASSET DEFINED.
>
> (a) In General.
>
> For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include —

3. On brief, petitioners assert a cost basis of $1.

(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business;

(3) a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by —

(A) a taxpayer whose personal efforts created such property,

(B) in the case of a letter, memorandum, or similar property, a taxpayer for whom such property was prepared or produced, or

(C) a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of a taxpayer described in subparagraph (A) or (B);

(4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1);

(5) a publication of the United States Government (including the Congressional Record) which is received from the United States Government or any agency thereof, other than by purchase at the price at which it is offered for sale to the public, and which is held by —

(A) a taxpayer who so received such publication, or

(B) a taxpayer in whose hands the basis of such publication is determined, for purposes of determining gain from a sale or exchange, in whole or in part by reference to the basis of such publication in the hands of a taxpayer described in subparagraph (A).

Petitioners contend that (1) the Court wrongly decided *Davis v. Commissioner*, 119 T.C. 1, 2002 WL 1446631 (2002), (2) a lottery ticket falls within the definition of a capital asset, and (3) characterization of a lottery ticket and the resultant prize as a capital asset does not frustrate congressional intent.

Davis involved the same issue and nearly identical facts. The taxpayers in *Davis* won a California State lottery prize and subsequently assigned a portion of future annual lottery payments to Singer in exchange for a lump-sum payment. *Id.* at

3. We held that the right to receive the future annual lottery payments did not constitute a capital asset within the meaning of section 1221. *Id.* at 7. We have repeatedly relied upon the analysis in *Davis . Clopton v. Commissioner*, T.C. Memo.2004-95; *Simpson v. Commissioner*, T.C. Memo.2003-155; *Johns v. Commissioner*, T.C. Memo.2003-140; *Boehme v. Commissioner*, T.C. Memo.2003-81.[4] No purpose would be served by repeating the analysis in *Davis* regarding why the right to receive future annual lottery payments does not constitute a capital asset.

Petitioners' remaining arguments all depend upon the determination that the lottery ticket was the property sold to Singer under the sale agreements. This argument was considered and rejected in *Simpson* and *Johns.*

Petitioners surrendered the lottery ticket to the Pennsylvania Lottery and claimed the lottery prize. The lottery prize was payable in 26 payments. Petitioners did not sell the lottery ticket to Singer, but rather their right to future lottery payments. Pursuant to our holding in *Davis v. Commissioner* and its progeny, we conclude that the $3,372,342 petitioners received from Singer is ordinary income and not capital gain.

To reflect the foregoing,

Decision will be entered for respondent.

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4. Accord *United States v. Maginnis*, 356 F.3d 1179, 1187 (9th Cir.2004) (holding that the amount that the taxpayer received in exchange for the taxpayer's assignment to a third party of his right to receive certain future annual lottery payments is ordinary income under the "substitute for ordinary income" doctrine).

Appendix B

UNITED STATES TAX COURT
Washington, DC 20217

Docket No. 4269-03.

GEORGE AND ANGELINE LATTERA,

Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

DECISION

Pursuant to the determination of the Court as set forth in its Opinion filed September 23, 2004, it is

ORDERED and DECIDED that there is a deficiency in income tax due from petitioners for the taxable year 1999 in the amount of $660,784.

s/ Juan F. Vasquez
Juan F. Vasquez
Judge

ENTERED: SEP 23 2004

APPENDIX C — ORDER OF THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT DENYING PETITION FOR REHEARING DATED AUGUST 11, 2006

UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

No. 04-4721

GEORGE LATTERA; ANGELINE LATTERA,

Appellants

v.

COMMISSIONER OF INTERNAL REVENUE

Appeal from the Decision of the
United States Tax Court Docket No. 4269-03

Present: SCIRICA, *Chief Judge*, SLOVITER, McKEE, RENDELL, BARRY, AMBRO, FUENTES, SMITH, FISHER, VAN ANTWERPEN, CHAGARES, *Circuit Judges* and DEBEVOISE,* *District Judge*

SUR PETITION FOR *EN BANC* REHEARING

The petition for rehearing filed by Appellant having been submitted to the judges who participated in the decision of this Court, and to all the other available circuit judges in active service, and no judge who concurred in the decision having

* Honorable Dickinson R. Debevoise, Senior District Court Judge for the District of New Jersey, sitting by designation is limited to panel rehearing only.

asked for rehearing, and a majority of the circuit judges of the circuit in regular active service not having voted for rehearing by the court *en banc*, the petition for rehearing is DENIED.

By the Court,
/s/ Thomas L. Ambro, Circuit Judge

Dated: August 11, 2006